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David L. Wolfe

Ralph E. DeJong

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*David L. Wolfe**
*Ralph E. DeJong***

I. Introduction

A critical business decision facing the owner of a new enterprise is the selection of the proper form of business organization. In making this decision, the owner needs to consider a substantial number of immediate and long-term business objectives, tax and nontax factors, and the ease with which the chosen form can be changed in the future.

The choice of alternative forms of business organizations varies at its most basic level, depending upon the number of persons who will own the business. An individual owner must operate the business either as a proprietorship or as a corporation. If he elects the corporate vehicle, it will be taxed as a separate entity at regular corporate federal income tax rates (a "C corporation") unless he elects under Subchapter S of the Internal Revenue Code[1] to have the corporate tax items passed through directly to its shareholder (an "S corporation").

In contrast, if several individuals own the business, the most common and versatile alternatives include a general partnership, a limited partnership, a C corporation taxed separately at regular corporate rates, or an electing S corporation (assuming that the Subchapter S requirements are satisfied[2]). Business owners also commonly use these organizational forms in combination in order to accomplish particular objectives. For example, in certain circumstances a corporation may function as the sole general partner in a limited partnership.

While it is generally recognized that the initial choice of organizational form is fundamental to the entire business planning process, many business planners fail to recognize the need to review the original decision periodically in light of operational experience, changing business needs, and changes in the governing laws, particularly in the tax area. This is a fundamental mistake which can result in the loss of significant benefits to both the business entity and the individual owners.

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* Partner, Gardner, Carton & Douglas, Chicago, Illinois.
** Associate, Gardner, Carton & Douglas, Chicago, Illinois.

1. I.R.C. §§ 1361-1379 (1983).
2. For a discussion of the requirements for a Subchapter S election, see *infra* section V.

II. Impact of Recent Tax Legislation

Three separate federal tax statutes, all enacted within a fourteen-month period, provide striking examples of how subsequent legislation can significantly alter the tax consequences of a client's original choice of business form. The first of these statutes was the Economic Recovery Tax Act of 1981 (ERTA),[3] which was intended primarily as a tax-reduction program.[4] Among its tax-reduction provisions, ERTA reduced the top federal income tax rate for an individual taxpayer's "unearned" (or "personal service") income from 70% to 50%.[5] Because this 50% maximum rate is only marginally higher than the maximum 46% rate imposed on C corporations,[6] the immediate tax cost of electing Subchapter S status for a profitable corporation has thus been virtually eliminated.[7] Nevertheless, business planners are well advised to consider a Subchapter S election for profitable businesses confronted with traditional corporate tax problems such as double taxation, unreasonable accumulations of earnings, and unreasonable compensation levels. None of these tax problems has been eliminated by the enactment of ERTA. A subchapter S election should also be considered for nonprofitable ventures so that losses may be passed through to the shareholders.

The second federal tax statute that Congress recently enacted was the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA).[8] A number of the important changes in TEFRA were based on the congressional perception that the more favorable planning opportunities available for corporations in the tax-qualified employee retirement plan area were playing a major, and often dispositive, role in the choice of organizational form.[9] The legislative response was a major effort to eliminate much of this perceived corporate advantage by substantially revising employee retirement plan requirements and restrictions, and by imposing them based on the number of

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3. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172 (codified as amended in scattered sections of 26 U.S.C.) (Supp. V 1981). Hereinafter, this statute will be cited as ERTA.

4. *See, e.g.*, STAFF OF JOINT COMM. ON TAXATION, 97TH CONG., 1ST SESS., GENERAL EXPLANATION OF THE ECONOMIC RECOVERY ACT OF 1981 at 17 (Joint Comm. Print 1981) ("Congress concluded that a program of significant multi-year tax reductions was needed to ensure economic growth in the years ahead. . . . Accordingly, Congress chose a program of broadly based tax cuts that it believed would improve incentives to work, produce, save, and invest, consistent with the goal of eliminating the Federal budget deficit by 1984.").

5. I.R.C. § 1 (as amended by ERTA § 101(a) (1983)).

6. *Id.* § 116.

7. *See infra* part V, section B, subsections 1 & 2.

8. Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324 (codified as amended in scattered sections of 26 U.S.C.) (1982). Hereinafter, this statute will be cited as TEFRA.

9. *See* STAFF OF JOINT COMM. ON TAXATION, 97TH CONG., 2D SESS., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982 at 308 (1982) ("Congress believed that the level of tax incentives made available to encourage an employer to provide retirement benefits to employees should generally not depend upon whether the employer is an incorporated or unincorporated enterprise.").

the participating employees rather than on the organizational form of the enterprise.[10] These new rules are generally effective for tax years beginning after December 31, 1983.[11]

While the third statute is much more limited in scope, it is of similar importance in the business planning arena. The Subchapter S Revision Act of 1982 (SSRA),[12] enacted on October 1, 1982, substantially altered virtually every tax-law aspect of S corporations, and generally became effective for tax years beginning after December 31, 1982. The underlying congressional purpose in enacting SSRA was to convert the S corporation into a much more complete passthrough tax vehicle, with federal income tax consequences similar to those of a partnership, while still maintaining the corporate form.[13] To accomplish this intent, SSRA revised the rules concerning passthrough of tax benefits to shareholders;[14] qualifications for S corporation status;[15] election, revocation and termination of S corporation status;[16] passive investment income restrictions;[17] and the taxation of corporate distributions.[18] As a result of the increased federal income tax similarities between an S corporation and a partnership, greater attention now should be placed on the nontax aspects of corporations and partnerships when selecting the business organization form.

III. Nontax Considerations Relevant to Selecting a Form of Business Organization

The concept of limited liability is commonly acknowledged to be the most important nontax factor in selecting a form of business organization. In a sole proprietorship, the owner is personally liable for the debts of his business. Similarly, in a general partnership, all of the partners are jointly liable for the partnership's obligations to the full extent of their individual assets.[19] In a limited partnership, however, the limited partners are shielded from

10. *Id.* at 309 ("Congress concluded that the level of tax incentives should be the same for all employees who maintain qualified plans, with the exception of employers whose plans focus more than 90 percent of their benefits on key employees.").

11. TEFRA § 241(a).

12. Subchapter S Revision Act of 1982, Pub. L. No. 97-354, 96 Stat. 1669 (codified as amended in scattered sections of 26 U.S.C.) (1982). Hereinafter, this statute will be cited as SSRA.

13. *See* Senate Comm. on Finance, Subchapter S Revisions Act of 1982, S. Rep. No. 640, 97th Cong., 2d Sess. 5, *reprinted in* 1982 U.S. Code Cong. & Ad. News 3257 (1982).

14. SSRA § 2, 96 Stat. 1677-79 (codified as amended at I.R.C. § 1366 (1983)).

15. *Id.* § 2, 96 Stat. 1669-72 (codified as amended at I.R.C. § 1361 (1983)).

16. *Id.* § 2, 96 Stat. 1672-76 (codified as amended at I.R.C. § 1362 (1983)).

17. *Id.* § 2, 96 Stat. 1684 (codified as amended at I.R.C. § 1375 (1983)).

18. *Id.* § 2, 96 Stat. 1680-81 (codified as amended at I.R.C. § 1368 (1983)).

19. Unif. Partnership Act § 15, 6 U.L.A. 1, 174-75 (1969). Partners are both jointly and severally liable for loss or injury to third parties resulting from a partner's wrongful act, *id.* § 13, 6 U.L.A. at 163; or from a partner's breach of trust, *id.* § 14, 6 U.L.A. at 173. In addition, liability for partnership debts has been made both joint and several in a number of states by special declaration. *Id.* § 15 official comment, 6 U.L.A. at 175.

personal liability to partnership creditors if they are true limited partners and they do not participate in the management of the business.[20]

The corporate shareholder's potential liability, on the other hand, is generally limited to the amount of his investment, regardless of his management activity.[21] This result is unchanged in the case of an electing S corporation because the election concerns only the treatment of a corporation and its shareholders under federal income tax law. Thus, where the principal investors intend to be active in managing the business, and the venture involves a relatively high degree of risk, limited liability may well be the key nontax consideration favoring use of the corporate vehicle.

A second nontax factor to consider when selecting a business entity is the ease of forming that entity. The formation of a proprietorship requires literally nothing more than establishing a business bank account. Similarly, there are no legal formalities required to establish a general partnership. Although a written partnership agreement, which defines the relative rights and duties of the partners, is not legally required, the absence of such an agreement often proves disastrous in later years. This is so even for a small family-owned business. A written partnership agreement is essential in the formation of a limited partnership, however, and a certificate outlining the terms of the agreement must be filed with the appropriate state office.[22]

The formation of a corporation is also relatively routine in most cases. All that is necessary is the filing of articles of incorporation, the drafting of bylaws, and the documenting of the organizational meeting of the directors. The requirements of Subchapter S complicate this process slightly because the incorporator must show that the corporation qualifies for the election and that the formalities of the election process were followed.[23]

Other traditional corporate characteristics, such as transferability of interests, continuity of existence, and centralized management, also serve as significant nontax considerations. While corporate shares and limited partnership interests may be freely transferred or assigned (subject in the latter case to the terms of the underlying partnership agreement)[24] without affecting the existence of the respective entities, transfer of a general partnership interest usually necessitates execution of a new partnership agreement.[25]

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20. UNIF. LIMITED PARTNERSHIP ACT § 7, 6 U.L.A. 561, 582 (1969).

21. This is true unless, for example, he is required to provide personal guarantees on behalf of the corporation.

22. UNIF. LIMITED PARTNERSHIP ACT § 2, 6 U.L.A. 561, 568 (1969). This section enumerates the required contents of the certificate of limited partnership.

23. Section 1362 outlines the process by which a small business corporation may elect S corporation status. I.R.C. § 1362 (1983). To be eligible, a corporation must be domestic and must not have, inter alia, over 35 shareholders, a corporate or nonresident alien shareholder, or more than one class of stock. *Id.* § 1361(b).

24. UNIF. LIMITED PARTNERSHIP ACT § 19(1), 6 U.L.A. 561, 603 (1969).

25. *See* UNIF. PARTNERSHIP ACT § 27(1), 6 U.L.A. at 353. An assignee of a partnership interest merely obtains the right to receive the assigning partner's share of the profits. Unless the original partnership agreement provides otherwise, the subsequent assignee may not participate in the administration or management of the partnership business. Therefore, the prudent assignee will require the remaining partners to enter into a new partnership agreement. *Id.*

Similarly, although a corporation or limited partnership continues as a separate legal entity despite the death, retirement, legal incompetence or bankruptcy of a shareholder or limited partner,[26] any of these events causes a formal dissolution of a general partnership.[27] Finally, centralized management is absent in the case of a general partnership because all partners normally have management rights and responsibilities.[28] The management rights of a limited partner, on the other hand, must be substantially restricted to prevent the imposition of personal liability for partnership debts of the limited partners. The management of a corporation is usually less cumbersome because it is centralized in a board of directors elected by shareholders.[29]

A final nontax consideration that should not be overlooked is the annual maintenance cost of the business form being considered. The corporate form is subject to various operational costs, such as qualification to do business in other states, preparation of annual reports, documentation of corporate actions taken by the shareholders or the board of directors, and payment of franchise taxes to one or more states. This degree of formality, along with its accompanying cost, is not required for either type of partnership, although major partnership decisions should certainly be documented.

In summary, the nontax characteristics of a C or an S corporation are at least conceptually more attractive than those of a general partnership. On a nontax basis, the limited partnership is somewhat of a hybrid vehicle; although the limited partnership resembles the corporate form in most respects, a general partner in a limited partnership will find his interest governed by the general partnership rules.[30]

It should be emphasized, however, that these conceptual nontax differences between corporations and partnerships can be, and often are, minimized or eliminated entirely to meet the needs of a particular enterprise. For example, corporate organizational documents or shareholder agreements can be drafted to restrict shareholder rights to an extent not mandated by state law, such as by limiting the transfer of shares to outsiders. Alternatively, a partnership agreement can be drafted that incorporates the desired corporate characteristics into the partnership. However, such drafting should be undertaken with some degree of restraint in order to avoid transforming the entity into an association taxable as a corporation.[31]

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26. UNIF. LIMITED PARTNERSHIP ACT § 21, 6 U.L.A. at 605.

27. UNIF. PARTNERSHIP ACT §§ 31-32, 6 U.L.A. at 376, 394. The Act does not prohibit the remaining partners from entering into a new partnership agreement and continuing the business thereafter.

28. *Id.* § 9(1), 6 U.L.A. at 132 ("[e]very partner is an agent of the partnership for the purpose of its business"); *id.* § 18(e), 6 U.L.A. at 213 ("All partners have equal rights in the management and conduct of the partnership business.").

29. MODEL BUSINESS CORP. ACT § 35 (1979).

30. UNIF. LIMITED PARTNERSHIP ACT § 9(1), 6 U.L.A. 561, 586 (1969).

31. The business advisor should be aware of the fact that corporations and partnerships could be used in tandem to achieve a combination of advantages that are not available through any single entity. These advantages, however, should be compared with the resulting increases in complexity and administrative expense.

IV. Basic Tax Characteristics

Tax considerations are often decisive in the choice of organizational form. Although SSRA has substantially minimized the differences between the tax aspects of partnerships and S corporations, an analysis of the principal federal income tax consequences of each of the three most common tax vehicles (i.e., partnerships, C corporations, and S corporations) is an essential prerequisite to deciding which is the most appropriate in a particular situation.[32]

A. *Partnership*

Despite their substantial nontax differences, general and limited partnerships are usually subject to similar taxation under Internal Revenue Code Subchapter K.[33] Under the Code, a partnership is not a separate taxable entity; rather, its income, gains, losses, deductions, and credits pass directly to the partners and retain their original character on the partners' personal returns.[34] Since partners are taxed on their allocable share of partnership income whether or not the income is actually distributed to them, no additional tax is imposed on the distribution of the income to them. The effective tax rate on partnership income is thus a function of the individual partners' tax brackets, which may reach a maximum of 50% under ERTA.

Under Section 704(d), a partner may deduct his allocable share of partnership losses to the extent of the adjusted basis of his partnership interest.[35] This basis includes cash and the adjusted basis of any other property that he has contributed to the partnership, as well as his share of partnership liabilities for which he is "at risk" under the rules of Section 465.[36] Losses greater than the adjusted basis may be carried forward indefinitely.[37]

Partnerships also offer a great deal of flexibility in the prospective allocation of income and losses, as long as the special allocation does not have substantial economic effect.[38] In addition, in many cases a partnership can

32. For a detailed comparative analysis of the principal federal income tax consequences of the partnership, C corporation, and S corporation, see *infra* Appendix.

33. I.R.C. §§ 701-761 (1983).

34. *Id.* § 702(a) ("[i]n determining his income tax, each partner shall take into account separately his distributive share of the partnership's . . . income, gain, loss, deduction, or credit").

35. *Id.* § 704(d).

36. *Id.* § 465(b). Amounts considered "at risk" are those borrowed for the use of the partnership, to the extent of the partner's personal liability or the fair market value of the partner's personal property pledged as security. *Id.* Money is not at risk if borrowed from anyone who has an interest (other than as a creditor) in the partnership or who is related to a partner in some way. *Id.; see also* I.R.C. § 705 (determination of basis of partner's interest); *id.* § 722 (basis of contributing partner's interest); *id.* § 733 (basis of distributee-partner's interest).

37. Losses in excess of the adjusted basis of the partner's interest are deducted at the end of the year in which such excess is repaid to the partnership. I.R.C. § 704(d). The passthrough of losses is particularly attractive in the case of passive "tax-shelter" investments where the loss results from a noncash expense (such as depreciation) which is accompanied by cash distributions to the partners.

38. *See id.* § 704(a) ("A partner's distributive share of income, gain, loss, deduction, or credit shall . . . be determined by the partnership agreement."); *id.* § 704(b) ("A partner's

be liquidated, divided into separate businesses, or converted into a different type of entity on a nontaxable basis with relative ease.[39] However, because most nontaxable fringe benefits are available only to "employees," such benefits are not similarly available to a partner.[40]

B. C Corporation

1. Double Taxation

Under the rules of Subchapter C of the Code, C corporations are separate taxpaying entities that currently pay federal income tax at the following rates:[41]

Tax Years Beginning After 1982

Taxable Income	*Tax Rate*
$ 0- 25,000	15%
$ 25,001- 50,000	18%
$ 50,001- 75,000	30%
$ 75,001-100,000	40%
Over $100,000	46%[42]

Corporate earnings are fully taxed to the C corporation when earned, without reduction for any amounts distributed to shareholders. Distributions in the form of dividends are then taxed again as ordinary income to the shareholders. If the earnings are not distributed as dividends, but are retained by the corporation, the "second tax" may be deferred to a subsequent year of distribution or even converted to capital gain if the C corporation is liquidated or the shares are sold. Under certain circumstances, however, retained earnings are subject to the imposition of an accumulated earnings tax and a tax on personal holding companies.[43]

The combined effective rate of the double tax depends on the interrelationship between the rate paid by the C corporation, the marginal tax brackets of its shareholders, and the character of the income realized at the corporate and shareholder levels. For example, if corporate earnings are taxed at the 46% rate and then distributed as dividends to a shareholder in the maximum 50% bracket, the total effective tax rate is 73%.[44] On the other hand,

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distributive share . . . shall be determined in accordance with the partner's interest in the partnership . . . if [the agreed allocation] does not have substantial economic effect.").

39. *See, e.g., id.* § 708(b)(2) (1983) (interest in partnership continues despite merger or division of partnership).

40. *See, e.g., id.* § 101(b) (a death benefit of up to $5,000, paid by the employer upon an employee's death, will not constitute gross income to the recipient).

41. *Id.* § 11(b) (1983). Prior to ERTA, the tax rates for C corporations were 17% of taxable income of $25,000 or less, and 20% of taxable income of $25,001 to $50,000. I.R.C. § 11(b) (1978), *amended by* ERTA § 231(a) (1981).

42. A special alternative tax rate of 28% is provided for a C corporation's long-term capital gain. I.R.C. § 1201(a) (1983).

43. *See infra* notes 44-45.

44. The maximum corporate tax rate is 46%. At this rate, only 54% of the income is available for distribution to the shareholder. If the entire remaining income is distributed as a dividend

if a 50% bracket shareholder receives accumulated corporate income as long-term capital gain upon liquidation, sale or redemption, the total effective rate of tax is 56.8% (46% at the corporate level and 10.8% at the shareholder level—due to the interplay of the 60% capital gains deduction).

2. Reducing the Impact of the Double Tax: Opportunities and Restrictions

A C corporation's ability to avoid the double tax is somewhat limited. If the corporation foregoes dividend distributions in the hope of converting accumulations of corporate income into capital gains at the shareholder level through a later sale or redemption of shares, it may be subject to the imposition of the accumulated earnings tax[45] and the tax on personal holding companies.[46] If, as an alternative or supplemental strategy for distributing corporate income to shareholders on a deductible basis, the corporation awards additional salary, bonus, interest on shareholder loans, or rent under asset-leasing arrangements, such awards may well be attacked by the Internal Revenue Service on the basis of any one of several open-ended theories. If the Service concludes that the deductible distributions are solely tax avoidance measures, it may reclassify the debt instruments as equity,[47] reallocate the tax items between the shareholders and the corporation,[48] and convert the compensation, interest or rental payments to shareholders into dividends under the "ordinary and necessary" business deduction provision.[49] While corporate losses are not deductible by shareholders, net operating losses

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to a shareholder in the 50% bracket, the shareholder, after paying personal income tax, will be left with only 27% of the corporate income. Thus, 73% of the income is paid out in taxes.

45. *See* I.R.C. §§ 531-537 (1983). The accumulated earnings tax rate on accumulated taxable income is 27.5% on amounts not exceeding $100,000, plus 38.5% on any amount over $100,000. *Id.* § 531. Taxable income is adjusted by a dividends paid deduction and an accumulated earnings credit. *Id.* § 535. A corporation may retain earnings to meet "the reasonably anticipated needs of the business" and the amount needed to redeem stock, under certain circumstances, from private foundations and deceased stockholders. *Id.* § 537. The accumulation of earnings beyond reasonable business needs is "determinative of the purpose to avoid the income tax. . . ." *Id.* § 533.

46. *See id.* §§ 541-547. A tax of 50% is imposed on undistributed personal holding company income. *Id.* § 541. Generally, a personal holding company is a corporation with more than 50% of its stock held by not more than five individuals, if at least 60% of its adjusted gross income is personal holding company income, *id.* § 542, which is derived from certain dividends, annuities, rents, royalties, personal service contracts, estates, and trusts. *Id.* § 543.

47. *Id.* § 385. Factors to be considered in determining whether an interest in a corporation is to be treated as stock or debt include whether there is a written unconditional promise to pay, at a fixed interest rate, a sum of money in return for adequate consideration; whether there is convertibility into the stock of the corporation; and the corporation's debt-equity ratio. *Id.*

48. The gross income, deductions, credits, or allowances of two or more organizations, trades, or businesses, owned or controlled by the same interests, may be reallocated by the Internal Revenue Service in order to prevent tax evasion or to reflect clearly the income of the organizations, trades, or businesses. *Id.* § 482 (1983).

49. *Id.* § 162. Reasonable compensation for personal services, business travel expenses (if not extravagant), and required rental payments are included within the "ordinary and necessary" business expenses that may be deducted. *Id.* § 162(a).

may be carried back or forward at the corporate level to reduce corporate taxable income in other years.[50]

3. *Retirement Income and Fringe Benefits for Shareholder-Employees*

Prior to TEFRA and SSRA, one of the principal tax advantages of a C corporation over a partnership was in the allowance of deductions for retirement income and fringe benefits for shareholder-employees. Partnerships were denied this advantage because, unlike corporate owner-managers, partners were not considered to be their own employees.

Both partnerships and corporations may establish qualified retirement plans.[51] Under either organizational form, the sponsoring entity's contributions are deductible when paid, but the participating employee or partner generally is not taxed until distributions are actually made to him or on his behalf after termination of employment.[52] Although both partnerships and corporations may establish qualified retirement plans, the plans for corporations have been far more advantageous than those for partnerships. For instance, the Internal Revenue Code permits employers to contribute annually a maximum of the lesser of $30,000 or 25% of the participant's compensation.[53] Annual contributions by self-employed individuals such as partners, however, have been limited to a maximum of the lesser of $15,000 or 15% of earned income.[54]

For taxable years beginning after December 31, 1983, TEFRA generally eliminates the tax distinctions between qualified plans sponsored by corporations and those established by self-employed individuals. A number of special Keogh plan restrictions are repealed, including those which (1) set lower limits on contributions and benefits for self-employed individuals; (2) prevent some Keogh plans from limiting coverage to a fair cross section of employees; (3) restrict potential integration with social security; (4) limit or preclude nondeductible voluntary employee contributions by an owner-employee; and (5) require that the plan trustee be a bank or other approved financial institution.[55] Other special Keogh plan rules are extended to all qualified plans and others are extended, with some modifications, to plans of both corporate and noncorporate employers that primarily benefit key employees (i.e., so-called top-heavy plans).[56] Nonetheless, due to the delay in the effec-

50. *Id.* § 172 (permitting the typical corporation to carry back a net operating loss to each of the preceeding three taxable years or to carry forward the loss to each of the following 15 taxable years).

51. *Id.* § 401.

52. *Id.* § 402 (employee's benefits are taxed when distributed); *id.* § 404 (employer's contributions to plan are deducted when paid).

53. *Id.* § 415.

54. *Id.* § 404(e)(1).

55. TEFRA § 237 (amending I.R.C. § 401(a), (d) (1983)).

56. *Id.* § 237(d) (penalty for early withdrawal limited to key employees in top-heavy plans); *id.* § 242(a) (rules restricting distributions from qualified plans); *id.* § 249(a) (nondiscriminatory coordination of defined contribution plans with employer contributions to Old Age, Survivors, and Disability Insurance under title II of the Social Security Act).

tive date for these changes, the comparative advantages of corporate plans over partnership plans remain in effect for taxable years beginning before 1984.

Fringe benefits, other than retirement plan programs, also have been more advantageous for corporations. For example, medical benefits paid to or on behalf of a sick or injured employee, or compensation to employees in connection with personal injury or sickness, are deductible by a corporation and are generally not includable in the employee's income even if he is also the principal stockholder.[57] A partner, however, is subject to the same rules applicable to individual taxpayers concerning the deductibility of medical expenses. These rules are substantially more restrictive than those that are applicable to employees.[58]

Similarly, a corporate employee is not taxed on premiums paid by his employer (on a deductible basis) for group-term life insurance providing up to $50,000 in death benefits.[59] Although no such benefit is available in the partnership setting, TEFRA restricts this group-term life insurance benefit for corporate employees by imposing certain nondiscrimination rules on such plans, effective for taxable years beginning after 1983.[60] Thus, to the extent that group-term life insurance plans discriminate in favor of key employees on the basis of eligibility to participate or the type and amount of benefits available, the $50,000 exclusion will not be available.[61]

In addition, a corporate employee's estate or beneficiary is not taxed on up to $5,000 in death benefits paid on his behalf by his employer.[62] For persons dying after December 31, 1983, Keogh plans will also qualify for the $5,000 death benefit exclusion for amounts paid to the beneficiary or estate of a self-employed individual.[63] Finally, special tax treatment is available in certain cases to corporate employees under employee stock purchase plans[64] and incentive stock option plans.[65]

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57. I.R.C. § 104 (1983) (compensation for injuries or sickness not includable in employee's gross income); id. § 105 (benefits received under health and accident plans not includable in employee's gross income); *id.* § 162 (ordinary business expenses are deductible from gross income of business).

These Code sections, when applied to nontaxation of medical benefits to principal shareholders, are subject to the nondiscrimination rules imposed on self-insured medical expenses reimbursement plans. *Id.* § 105(h).

58. *Id.* § 213. An individual is allowed a deduction for medical expenses only to the extent that such expenses exceed 5% of adjusted gross income. *Id.* § 213(a). An individual may include expenses for medicine and drugs in computing his deduction for medical expenses, but only to the extent that such amounts exceed 1% of adjusted gross income. *Id.* § 213(b).

59. *Id.* § 79.

60. TEFRA § 244(a).

61. A group term life insurance plan is not discriminatory if the plan benefits at least 70% of the employees, at least 85% of the participants are not key employees, or the plan is found by the Secretary not to be discriminatory. *Id.*

62. I.R.C. § 101(b) (1983).

63. TEFRA § 239.

64. I.R.C. § 423 (1983).

65. *Id.* § 422A.

C. S Corporation

1. Treatment of S Corporation Income and Losses to Shareholders

The primary effect of the Subchapter S election is to pass the income or loss of the S corporation directly to its shareholders. The S corporation thus generally ceases to act as a separate taxpayer and its tax return merely becomes an informational return. The manner in which corporate income, losses, and distributions are taxed to a shareholder of an S corporation, however, has been entirely rewritten by SSRA.

The basic result of SSRA is that S corporations and their shareholders will be taxed much more like partnerships and their partners. At the corporate level, these fundamental changes loosely fall within a number of categories, including the following: (1) a more complete passthrough of tax items directly to the shareholders; (2) a liberalization of the qualification requirements, making the election available to a greater number of small businesses operated in corporate form; (3) an easing of the potential for, and negative consequences of, inadvertent termination of S corporation status; and (4) the extension of a number of partnership rules and restrictions to S corporations, including choice of taxable year, fringe benefit limits, and TEFRA partnership audit rules.

At the shareholder level, each shareholder takes into account his pro rata share of the income, losses, deductions, credits, and tax preference items passed directly through by the corporation. The shareholder also takes his pro rata share of the S corporation's nonseparately computed income or loss.[66] The pro rata share of such items is determined on a per share, per day basis, rather than on a year-end ownership basis.[67] Additionally, the character of each item included in the shareholder's pro rata share is passed through to the shareholder by the corporation.[68] Thus, the character of each item is determined as if the item were realized directly by the shareholder rather than by the corporation.

SSRA, again designed to treat the shareholder more like a partner, also changes the rules applicable to losses passed through to a shareholder. A loss is passed through as a fully deductible ordinary loss, but the deduction is limited to the shareholder's adjusted basis in corporate stock, plus his adjusted basis in any debt the corporation owes him.[69] Any loss in excess of that amount can now be carried forward indefinitely to any subsequent year in which the shareholder has an adequate basis in corporate stock or debt.[70]

The adjustments to the shareholder's basis in corporate stock and debt also parallel the partnership rules. Corporate income that is passed through

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66. *Id.* § 1366(a).
67. *Id.* § 1377(a).
68. *Id.* § 1366(b).
69. *Id.* § 1366(d)(1).
70. *Id.* § 1366(d)(2).

to the shareholder but is not distributed by the corporation increases his basis, while corporate loss that is passed through reduces his basis.[71] As stated above, if the basis is reduced to zero, any remaining loss must be carried forward to a year in which the basis is greater than zero.

2. *Treatment of S Corporation Distributions to Shareholders*

A distribution by an S corporation is equal to the amount of cash distributed plus the fair market value of any property distributed. If the corporation has no accumulated earnings and profits (E & P), a distribution is treated as a tax-free return of capital to the extent of the shareholder's basis in his stock (with a corresponding basis reduction).[72] If the distribution exceeds the shareholder's basis, the shareholder will generally recognize a capital gain.[73]

If, on the other hand, the S corporation has accumulated E & P, the distribution is not treated as a dividend but rather as if made by a corporation without E & P (tax-free to the extent of basis, and long-term capital gain thereafter) to the extent of the corporation's "accumulated adjustments account."[74] The accumulated adjustments account contains the S corporation's accumulated post-1982 income (less most deductions) that has not been distributed.[75] The purpose of the account is to allow the S corporation to make tax-free distributions of income earned after 1982 that has been taxed, but not yet distributed, to the shareholders. The amount of a distribution that exceeds the accumulated adjustments account is treated as a dividend to the extent of accumulated E & P, and any further excess reduces the shareholder's basis.[76] If the distribution exceeds both accumulated E & P and the shareholder's basis, the remaining amount is generally capital gain.[77]

V. Using the Subchapter S Election as a Tax-Saving Device

A. *Potential Tax Benefits for a Newly Organized or Incorporated Business*[78]

1. *Passthrough of Losses During Start-Up Phase*

Many newly organized businesses experience operating losses during their formative years because of their need to develop products, markets, and manufacturing facilities. Other new businesses may become profitable almost immediately but still experience early periods of tax losses due, for example,

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71. *Id.* § 1367.
72. *Id.* § 1368(b)(1).
73. *Id.* § 1368(b)(2).
74. *Id.* § 1368(c).
75. *Id.* § 1368(e)(1).
76. *Id.*
77. For a detailed comparative analysis of the principal differences in federal income tax consequences of the partnership, C corporation, and S corporation, see *infra* Appendix.
78. For example, an existing unincorporated business may adopt a different accounting method, upon incorporation, without the approval of the Service. Treas. Reg. § 1.446-1(e) (1960).

to timing differences between payment of expenses and receipt of income under the cash method of accounting. If the S corporation's shareholders furnish the corporation's start-up capital, either from their own resources or through third-party loans to the shareholders that are in turn contributed or loaned to the corporation, and if they have sufficient other income to absorb the losses, the Subchapter S election provides them with a current benefit from the loss, as well as from any investment tax credits arising during the loss period. If the shareholder does not have sufficient other income to absorb the losses, the resulting net operating loss (NOL) at the shareholder level can be carried back for three years and carried forward for fifteen years under the general rules governing NOLs.[79] Moreover, for the first time, loss passthroughs in excess of the shareholder's combined stock and debt basis in the S corporation are not lost forever; rather, they can be carried forward indefinitely and deducted in any subsequent year in which the shareholder has an adequate basis in his stock or in debt the corporation owes him.[80]

This latter rule is essentially identical to the rule governing partnership losses in excess of a partner's basis in his partnership interest.[81] The carryforward permits an S corporation shareholder with a passthrough loss to time the purchase of a deduction in any subsequent year, as needed, by contributing (or loaning) an amount equal to such excess or part thereof to the corporation.

Losses of a C corporation, on the other hand, and any investment tax credits arising during the loss period, do not result in a current tax benefit at either the corporate or the shareholder level, due to the absence of the passthrough concept. In general, the future tax benefits at the corporate level, under the net-operating-loss and unused-credit carryover rules for a C corporation, provide less favorable tax benefits due to timing and tax rate differentials along with the possible expiration of the carryovers before utilization. While such a passthrough of losses can also be achieved through a partnership, as stated above, use of a partnership vehicle may well result in the loss of extremely important nontax benefits of the corporate form, such as limited liability and management control.

2. Capital Gain Conversion Potential

As noted in the preceding section, an S corporation shareholder who receives a corporate loss passthrough in excess of his equity and debt basis can carry the excess forward to a later year as an ordinary loss. Through the timing of further capital contributions or loans to the corporation, the shareholder controls the year in which the carryover loss is recognized.

For example, Mr. Smith is the sole shareholder of an S corporation and

79. I.R.C. § 172 (1983).
80. *Id.* § 1366(d)(2).
81. *Id.* § 704(d).

both report income on a calendar-year basis. In 1983, when Smith's basis in the corporation is only $30,000, he receives a loss passthrough of $50,000. The $20,000 by which the loss passthrough exceeds his basis is not immediately deductible, so Smith carries the excess forward to later years. In 1984, he contributes an additional $20,000 to the capital of the corporation. This contribution increases Smith's stock basis by an identical amount, permitting him to deduct in 1984 the remaining $20,000 carryover on the 1983 corporate loss. The deduction reduces his stock basis to zero.

By making the additional $20,000 capital contribution and thus using the $20,000 ordinary loss, Smith has gained the potential for converting ordinary income into capital gain. Any subsequent corporate distributions in excess of the S corporation shareholder's stock basis will be taxed as capital gain, subject to the 60% capital gain deduction.[82]

A similar result can be obtained through the use of debt evidenced by a bond or note, because an S corporation shareholder may offset his basis in both stock and debt with passed-through losses.[83] However, if the debt basis is not reduced to zero by the original loss passthrough, each subsequent principal repayment will be in part a nontaxable return of capital and in part capital gain (with the nontaxable portion based on the percentage that the remaining debt basis bears to the entire principal amount of the debt).

Continuing with this hypothetical, suppose the S corporation has $5,000 taxable income in 1985 but makes a $15,000 corporate distribution to Smith. As a result, $5,000 of the distribution would be treated as ordinary income on Mr. Smith's individual return. The additional $10,000, which exceeds Mr. Smith's stock basis of zero, will be treated as long-term capital gain. Thus, only 40% of this latter amount will be subject to tax.

3. *Retirement Income and Fringe Benefits for Shareholder-Employees*

While corporate loss passthrough can also be accomplished through a partnership vehicle, certain tax benefits available to shareholder-employees of C corporations and S corporations have not historically been available to partners.[84] Although qualified retirement plans of S corporations have historically been subject to certain special restrictions that were not imposed on plans of C corporations, Keogh plans used by partners were subject to even more restrictive rules and limits. These employee-benefit disadvantages of S corporations and partnerships, however, have been virtually eliminated under TEFRA and SSRA.

TEFRA has effectively placed the qualified retirement plans of both partnerships and S corporations on a par with C corporation plans for tax years beginning after 1983. Similarly, SSRA has eliminated the S corporation's deduction for nontaxable fringe benefit payments, such as death benefits, group-term life insurance, and accident and health benefits, to shareholders

82. *Id.* § 1202(a).
83. *Id.* § 1366(d)(1).
84. *See infra* part IV, section B.

who own more than 2%[85] of the S corporation's stock. However, in the case of an S corporation after 1983 that has only two employees—the sole shareholder and his spouse—medical benefits can be provided for the sole shareholder indirectly as a dependent under his spouse's coverage. The 2-percent shareholder's income exclusion for nontaxable fringe benefits has also been eliminated.[86]

B. *Potential Tax Benefits for Existing Corporations*

1. *Possibility of First-Level Tax Savings*

The logical first step in determining whether a Subchapter S election is appropriate in the case of a profitable C corporation is to compare the effective corporate federal income tax rate on current and projected future taxable income with the marginal individual tax rates of its shareholders. If the regular corporate tax liability is expected to exceed the aggregate amount of shareholder federal income tax liability that would result under the election (both computed on a present-value basis), the election results in a first-level federal income tax savings. This could be the case, for example, when the income would be split relatively equally among a number of shareholders, and especially when the shareholder group includes children without any other income.

Significant state tax savings may also be realized by a Subchapter S election. In Illinois, for example, a regular corporation pays income tax at a rate of 4% and replacement tax at a rate of 2.5% on its "base income" (federal taxable income plus or minus adjustments).[87] By contrast, an S corporation pays no income tax and pays replacement tax at a rate of 1.5%.[88]

2. *Eliminating the Second Tax on Dividend Distributions*

In many instances, the aggregate amount of shareholder liability under the Subchapter S election will exceed the regular corporate tax liability. Moreover, prior to ERTA,[89] the immediate cost of electing Subchapter S status for a profitable corporation could be quite substantial, because the maximum corporate tax rate is only 46%, but dividend distributions could be taxed at a rate as high as 70%. By reducing the maximum marginal individual tax rate to 50%, however, ERTA has reduced this potential immediate tax cost to such a degree that it will rarely be the controlling factor in the determination.

85. A "2-percent shareholder" is defined as a person who, directly or indirectly, owns more than 2% of the stock on *any day* during the taxable year. I.R.C. § 1372 (1983).

86. It should be noted, however, that the deduction and income exclusion are not lost for other shareholder-employees. *Id.* (generally effective for tax years beginning after 1982, but with a delayed effective date for up to five years for the preexisting nontaxable fringe benefits of corporations with an S corporation election in effect on September 28, 1982).

87. ILL. REV. STAT. ch. 120, § 2-201(b), (d) (1982).

88. *Id.* § 2-201(d).

89. ERTA is generally effective for tax years beginning after 1981.

The next step in the analysis is to factor in the cost of distributing after-tax earnings from the C corporation. If the distribution is in the form of a dividend from a C corporation, the impact of the second tax can be quite substantial. In contrast, undistributed earnings previously taxed to an S corporation's shareholders generally may be distributed on a tax-free basis while the election remains in effect.[90] If the aggregate immediate and projected tax liability at the shareholder level under the Subchapter S election is less than the sum of (1) the regular corporate tax liability on that income plus (2) the combined tax cost of the taxable dividend distributions to the shareholders (all computed on a present-value basis), the Subchapter S election will result in a net federal income tax savings by eliminating the impact of the double tax on such distributions.

In circumstances in which all of the earnings of the C corporation are to be distributed annually in the form of dividends, a Subchapter S election will regularly result in a net tax savings. If only a portion of the corporate earnings is to be distributed annually, then the Subchapter S election becomes more attractive as the percentage of earnings paid out in dividends increases. Where both the corporation and its shareholders are paying federal income tax at the maximum marginal rates, a net federal income tax savings will generally result if the corporation regularly distributes 15% or more of its pre-tax earnings in the form of dividends.

3. *Sale or Liquidation of the Business*

To the extent that dividend distributions are not made to the shareholders of a C corporation, the second tax on the corporate taxable income is deferred until the corporation is liquidated or a shareholder's interest is sold or redeemed. Since these undistributed earnings are not added to the shareholder's basis in his stock, he will generally recognize a long-term capital gain on the transaction if it occurs prior to his death. A post-death transaction may result in little or no gain due to the step-up in basis (to date-of-death or alternate-valuation-date value) that his estate obtains.[91] In contrast, since a shareholder in an S corporation is taxed on his pro rata share of the corporation's income each year, whether or not it is distributed, the income that is not distributed increases the shareholder's stock basis. Thus, the subsequent realization of such amounts will be nontaxable even in a taxable sale or liquidation.[92]

If the shareholders of a C corporation intend to liquidate or sell the business in a taxable transaction during their lifetime, the impact of the resulting long-term capital gain on the retained corporate earnings must also be factored into the Subchapter S determination. If the aggregate immediate tax payable at the shareholder level under the Subchapter S election is less

90. I.R.C. § 1368(c) (1983).

91. *Id.* § 1014(a).

92. *Id.* § 1367(a)(1).

than the sum of (1) the regular corporate tax on such income; (2) the tax payable on any dividend distributions to shareholders; (3) the tax, if any, imposed on accumulated earnings; and (4) the tax resulting from the capital gain on the retained earnings (all computed on a present-value basis), there will be a federal income tax savings by electing Subchapter S status.

The Subchapter S tax benefit resulting from the elimination of the second level of tax decreases in relative value as the percentage of earnings retained in the business increases. This is a result of the 60% net capital gain deduction under section 1202, which effectively reduces the maximum tax rate on an individual's net capital gain to 20%. In the case of a C corporation, however, the second tax can be eliminated only if no dividend distributions are made and the shareholders hold their stock until they either die or dispose of it in a tax-free transaction.

4. Elimination of Accumulated Earnings Problems

Because its income is taxed to its shareholders whether or not it is distributed, an S corporation is not subject to the accumulated earnings tax.[93] A C corporation confronted with an imminent accumulated earnings problem has three basic options: (1) risk the imposition of the penalty tax; (2) make taxable dividend distributions to shareholders; or (3) elect Subchapter S status, thereby both eliminating the problem and opening the door for possible tax-free distributions of previously taxed income. The immediate tax impact of the Subchapter S election can be determined by comparing the aggregate shareholder tax payable under the election with the sum of the regular corporate tax and the tax cost of the dividends that would otherwise have been required.

5. Maximizing Investment Return on Corporation Earnings

Because of the effect of the tax on dividend distributions, a C corporation may determine that retention of corporate earnings is in the best interests of its shareholders, even when the corporation anticipates that it will earn a lower rate of return on retained earnings than the return the shareholders could earn if the earnings were distributed. An existing business may not need this capital in its present operations, and it may also have difficulty establishing a new business line or expanding within existing managerial capabilities. An alternate strategy of developing an equity investment portfolio may be substantially restricted by the accumulated earnings limits. This may act to limit substantially the corporation's investment alternatives, thereby further reducing the overall investment return on these funds below the level that the shareholders themselves could obtain. It should also be emphasized that the retained cash often will be valued at less than 100 cents on the dollar upon a subsequent sale of the business assuming, for

93. *Id.* § 1363(a).

example, that the sales price is based on a multiple of earnings rather than net asset value.

In the case of an S corporation, this problem is eliminated. Because no greater tax liability is incurred if the earnings remain in the corporation or are distributed to the shareholders, the decision of whether to distribute corporate earnings should depend primarily on whether the corporation or the shareholders can make the most effective use of the capital. If the shareholders will be able to invest the funds at a higher rate of return through individual investment programs, the income should be distributed.

6. *Passthrough of Net Operating Losses, and Capital Gain and Loss Items*

The passthrough of losses is typically most important during the start-up phase of a business. However, the analysis in part five, subpart A, above also applies in the case of NOLs incurred by an existing corporation—for example, during a period of retrenchment. In addition, many profitable corporations generate NOLs for income tax purposes from time to time.

An S corporation, however, cannot deduct a carryforward or carryback loss arising in a year in which it was taxed as a C corporation.[94] For this reason, a C corporation with unexpired operating losses should carefully consider the potential loss of the corporate carryforward deduction for past losses in deciding whether to elect under Subchapter S. On the other hand, *future* corporate losses may be worth more if passed through to the shareholders under the election. Whether the S corporation election will result in a net tax savings in such a case generally depends on whether the resulting reduction in the shareholders' personal tax liability exceeds the amount of the refund or future reduction in corporate income that would result under the regular C corporation loss carryback and carryforward rules (both numbers computed on present-value basis).

New planning opportunities are also available through the new SSRA rule under which an S corporation's capital gains and losses are separately passed through to the shareholders. This is to be distinguished from the pre-SSRA rule under which a net capital loss could not be passed through to shareholders.[95] Under the new rules, the net capital loss passed through by the corporation can first be applied to reduce the personal capital gains of the respective shareholders, and any excess can be deducted from their respective incomes, subject to the usual limitations.[96]

7. *Elimination of Unreasonable Compensation Issue*

Since the Subchapter S election results in a single tax at the shareholder level, it also eliminates the unreasonable compensation issue, along with the

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94. *Id.* § 1371(b)(2).

95. Prior to the changes enacted in SSRA, the Code allowed only net operating losses to pass through to the shareholders. *Id.* § 1374 (1981), *amended by* I.R.C. § 1366 (1982).

96. I.R.C. § 1211 (1983).

accompanying potential loss of the corporate deduction that a C corporation may encounter if it pays a large portion of its income to its shareholders as salary. Because ERTA has lowered the maximum marginal individual tax rate to 50%, the disadvantage of the dividend recharacterization from the shareholder's perspective is now also eliminated.

8. Income Splitting

Division of income among family members through gifts of stock in an S corporation can also act to reduce the total family income tax burden substantially by shifting income from a high-bracket taxpayer to one or more low-bracket taxpayers, such as the children of the principal shareholder. However, because all corporate income is passed through to the shareholders on a per share, per day basis, income splitting can only be accomplished prospectively.

While income splitting can also be accomplished through gifts[97] of partnership interests, the Subchapter S rules remain at the present time somewhat more liberal than those applicable to family partnerships.[98] The principal limits on income shifting through an S corporation include the following: (1) a shareholder who is also an employee of the corporation must be adequately compensated or the Service may reallocate to him the income paid to other family members;[99] (2) under SSRA, the Service is also authorized to make discretionary reallocations when a shareholder has received insufficient compensation on capital;[100] (3) the stock must be transferred in a bona fide transaction and the donee must be the beneficial owner of the stock;[101] and (4) courts might apply other general tax principles, such as the assignment of income doctrine,[102] to reallocate income to the donor.

9. Income Deferral in Year of Election if Corporation Has a Fiscal Tax Year

While a partnership is restricted in choosing a fiscal tax year different from that of its principal partners,[103] a C corporation may adopt a fiscal tax year that is different from that of all its shareholders. Prior to SSRA, S corporations were not subject to the more restrictive partnership rule; therefore, the choice of a fiscal year for newly established S corporations

97. Income tax savings through income-splitting techniques may be offset by transfer tax considerations, although the liberalized $10,000 annual gift tax exclusion under ERTA lessens any offset. *Id.* § 2503.

98. *Id.* § 704(e).

99. *Id.* § 1366(e).

100. *Id.*

101. Treas. Reg. § 1.1373-1(a)(2) (1960) (presumably still applicable after SSRA).

102. *See* Lucas v. Earl, 281 U.S. 111 (1930) (contract to have future salary paid to third party is an invalid assignment of income and, thus, the salary is attributed to the person who actually earned it); Overton v. Commissioner, 162 F.2d 155 (2d. Cir. 1947) (transfer of newly created class of stock that had minimal value and no voting rights, but received over ⅔ of the cash dividends, was invalid assignment of income).

103. I.R.C. § 706(b)(1) (1983).

was a very popular income deferral strategy. Undistributed S corporation income was taxed at the end of the shareholder's tax year, rather than at the end of the corporate fiscal year. For example, even though all of its shareholders were calendar-year taxpayers, an S corporation could adopt an initial tax year ending on January 31, 1982. Under former law, a timely Subchapter S election would cause all of the corporation's undistributed taxable income for that year to be taxed to the shareholders as of the last day of the corporation's tax year (i.e., January 31).[104] This would have resulted in a perpetual eleven-month income deferral, because the shareholders would report this income on their individual returns for calendar year 1982.

SSRA, as amended by the Technical Corrections Act of 1982,[105] permits only corporations electing Subchapter S status before October 20, 1982, to establish a taxable year ending other than on December 31 without having to identify a satisfactory business purpose for employing a noncalendar taxable year. For such existing S corporations, perpetual income tax deferral potential remains available for up to eleven months per year (in the case of a January 31 corporate year-end) if the corporation had previously adopted a fiscal tax year and the shareholders are all calendar-year taxpayers. Such an S corporation can keep its existing fiscal year, however, only as long as at least 50% of the corporation's stock is owned by the same shareholders.[106]

Corporations that elect Subchapter S status on or after October 20, 1982, must generally demonstrate a business purpose for maintaining a noncalendar taxable year.[107] The Conference Committee Report for the Technical Corrections Act[108] stated that the business purpose test of Section 1378 should be satisfied when the corporation's fiscal year would defer income to the shareholders for three months or less. Limited deferral thus remains available for new S corporations either for up to a three-month period or through the showing of a satisfactory business purpose for a noncalendar taxable year.

VI. Eligibility, Election, Operational and Termination Rules Governing S Corporations

Sections 1361 through 1379 set forth numerous technical requirements and restrictions, which are both substantive and procedural in nature, governing the eligibility, operation, and termination of S corporations. These rules are of critical importance in the choice of an S corporation election, and they include the following particularly important substantive restrictions:

1. Limit of 35 shareholders;
2. Types of shareholders limited to individuals, estates and certain specified types of trusts;

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104. *Id.* § 1373 (1981), *amended by* I.R.C. § 1378 (1983).

105. Technical Corrections Act of 1982, Pub. L. No. 97-448, 96 Stat. 2365 (codified in scattered sections of 26 U.S.C.) (1982).

106. I.R.C. § 1378(c)(1) (1983).

107. *Id.* § 1378(b)(2).

108. H.R. Rep. No. 986, 97th Cong., 2d Sess. 22 (1982).

3. Limit of one class of stock outstanding (although SSRA provides a limited safe harbor against reclassification of debt as equity for certain straight debt instruments and also permits differences in voting rights);
4. Member of an affiliated group of corporations is not eligible for the election;
5. Requirement of affirmative election of S corporation status with restrictive procedural rules as to timing and form;
6. Limits on income from passive sources (although substantially liberalized by SSRA);
7. Special restrictions on qualified retirement plan benefits for 5% or more shareholder-employees (until plan years beginning in 1984 when new TEFRA top-heavy plan rules take effect);
8. Special restrictions on nontaxable fringe benefits for more than 2% shareholder-employees (similar to partnerships).[109]

VII. Conclusion

The dramatic changes implemented by SSRA make S corporations a much more viable alternative to partnerships from a tax perspective in such areas as tax-sheltered investments and business ventures in which early losses are anticipated. Also, the elimination of such restrictions as the passive income test makes the S corporation available in an expanded number of circumstances (for example, as an investment vehicle). Given the essentially identical tax results of S corporations and partnerships in most respects (the most fundamental distinction generally being a difference in basis computations), nontax characteristics will assume more importance than ever in determining which form of organization a business entity shall choose. In that regard, past attempts to mold partnerships (or multiple-entity concoctions) into something approximating the corporate form for nontax reasons may be rendered unnecessary in most cases, because S corporations now combine the advantages of corporate form and partnership taxation.

From a tax perspective, the SSRA also makes a Subchapter S election a viable alternative to a C corporation. The management of a C corporation that has the requisite number of shareholders (35 or less) and with pretax income in excess of $300,000 would be well advised to consider the following three questions:

1. Will election of S corporation status result in a current annual income tax savings (due to the presence of shareholder rates lower than the corporate rates and/or the elimination of the second tax on dividend distributions)?
2. Are the shareholders likely to dispose of their stock during their lifetime (i.e., at capital gain rates of up to 20%)?
3. Would the shareholders likely be able to invest the corporate retained earnings at a higher rate of return than is available to the corporation?

Management should consider the potential tax advantages of a Subchapter

109. I.R.C. § 1372 (1983).

S election if the answer to any of these three questions is in the affirmative. This determination should include an analysis of the 1983 restrictions on the maximum qualified retirement plan benefits available under the election, as well as the potential negative estate tax impact of restructuring the outstanding stock of corporations with two classes of stock currently outstanding. These considerations can all be reduced to monetary terms, with the ultimate determination being whether the Subchapter S election produces a significantly larger after-tax accumulation on a present-value basis.

APPENDIX

Basic Tax Factors in Selecting an Organizational Form

	Partnership	*S Corporation*	*C Corporation*
1. Level at which entity's net income is taxed:	Flow-through to investor level; taxed at investor's marginal rate, to maximum of 50%.	Flow-through to investor level except for certain capital gains; taxed at investor's marginal rate, to maximum of 50%.	Corporation as separate taxable entity pays tax at marginal rates up to 46%, subject to alternative 28% rate on long-term capital gain.
2. Ability to use entity's net losses to offset investor's other income:	Yes—to extent of adjusted basis of partner's partnership interest; adjusted basis includes adjusted basis of property contributed by partner, plus any gain recognized by the partner and partner's share of partnership's liabilities (partner's share of partnership's liabilities depends on two factors: his status as general or limited partner and classification of the liability as recourse or nonrecourse under the at-risk rules); excess loss may be carried forward to future years.	Yes—to extent of adjusted basis of shareholder's stock, plus any indebtedness owed by corporation to shareholder; excess loss can be carried forward indefinitely and deducted when shareholder obtains sufficient basis.	No—corporation can only carry a net operating loss back or forward to offset corporate income in other years.

	Partnership	S Corporation	C Corporation
3. Special allocations of income, loss, and other tax items and priorities in allocation and distribution of income:	Yes, if special allocations have substantial economic effect, but such allocations may not be made on retroactive basis.	No—must be in proportion to ownership share. Items of income, loss, deduction, or credit are allocated to each shareholder on a per share, per day basis.	No—must be in proportion to ownership share.
4. Ability to pass character of income, gains, losses, deductions, and credits to investor:	Yes	Yes—capital gains and losses, Section 1231 gains and losses, charitable contributions, credits, excludable interest and dividends, tax-exempt interest, foreign taxes, foreign income and loss, and limitations on the use or availability of an item generally pass through to the shareholders on a pro rata basis and retain their character.	No
5. Time at which partners or shareholders recognize entity's income:	At end of partnership's tax year, whether or not distributions have been made before year-end.	To the extent that distributions by a corporation having accumulated earnings and profits exceed the "accumulated adjust-	Corporate tax imposed at end of corporation's tax year; dividend distributions are taxable when paid.

			ments account,'' amounts distributed constitute dividends when made to the extent of corporate E & P; other distributions generally reduce the shareholder's basis and are thereafter treated as capital gain. Allocations of income items are included in the shareholder's gross income for the taxable year in which the corporation's taxable year ends.	
6.	Tax imposed on distribution of entity's earnings:	No	Possibly—distribution rules are highly technical and can result in ordinary income (to the extent that accumulated earnings and profits exceed ''accumulated adjustments account''), tax-free treatment (any further distribution offset by basis reduction), or capital gain (to the extent that distributions not supported by accumulated earnings and profits exceed shareholder's basis); also special new rules for distributions of appreciated property (i.e., treated as if first sold at current value).	Yes—dividends are taxed as ordinary income when paid; tax at shareholder level may be deferred and converted to capital gain upon liquidation of corporation or sale or redemption of shares.

	Partnership	S Corporation	C Corporation
7. Selection of entity's taxable year:	Partnership with all calendar-year partner-taxpayers can use tax year ending on September 30, October 31, November 30, or December 31.	Unless a satisfactory business purpose is shown, corporations electing Subchapter S status after October 19, 1982, are subject to partnership restrictions.	Can adopt any fiscal year even though all shareholders are calendar-year taxpayers.
8. Ability to elect an adjustment in basis upon transfer of investor's interest or distribution of property to investor:	Yes, but once election is made it applies to all subsequent transfers and cannot be revoked without IRS consent.	No	No
9. Character of gain upon sale of investor's interest:	Depends on assets sold—ordinary income may result from sale of items such as personal property (depreciation recapture), unrealized receivables and appreciated inventory; capital gains are otherwise available; investment tax credits may also be recaptured.	Sale of stock will be taxed as capital gain unless collapsible corporation rules apply; investment tax credits may be recaptured.	Sale of stock will be taxed as capital gain unless collapsible corporation rules apply; no investment tax credit recapture.

10.	Character of loss on sale of business:	Ordinary or capital.	Same as for regular corporation.	Unless the stock qualified as "Section 1244 stock," the entire loss on disposition is a capital loss, subject to possible severe limits on deductibility.
11.	Ease of converting form of entity:	Relatively simple to convert to corporation or to subdivide a business among co-owners without adverse tax consequences in many cases.	Can revoke election with relative ease to convert to regular corporate status, but may not again elect Subchapter S status for five years without IRS consent.	Relatively hard to convert to partnership in many cases; easier to accomplish tax-free merger with another corporation; division of business requires compliance with the complex rules of Section 355.
12.	Consequences of passive investment income:	None	No limit on passive investment income for corporations without earnings and profits remaining from status as C corporation; if corporation has such earnings and profits for three consecutive taxable years, and if in each such year more than 25% of gross receipts is from passive investment income, election is endangered.	Possible imposition of personal holding company tax.

	Partnership	S Corporation	C Corporation
13. Possible imposition of accumulated earnings tax:	No	No	Yes
14. Unreasonable compensation, interest, or rental issues:	No	No	Yes
15. Qualified retirement plan benefits:	Less favorable through 1983-84 plan year; parity thereafter.	Less favorable through 1983-84 plan year; parity thereafter.	More favorable through 1983-84 plan year; parity thereafter.
16. Other employee fringe benefits to investors:	No	Yes, but only for 2% or less shareholders.	Yes
17. Social Security payroll taxes:	Self-employment tax on partners; combined employer-employee rates for nonowner employees.	Combined employer-employee rates.	Combined employer-employee rates.